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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. —

UNITED STATES OF AMERICA, PETITIONER

v.

IDEAL BASIC INDUSTRIES, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (R. 64–77)[1] are not officially reported. The majority and dissenting opinions of the court of appeals (App. A, *infra,* pp. 1a–10a) are reported at 404 F. 2d 122.

JURISDICTION

The judgment of the court of appeals was entered on August 15, 1968 (App. B, *infra,* p. 11a). The government's petition for rehearing *en banc* was denied

[1] "R." references are to the printed record in the court of appeals. "App." refers to the appendices to this petition.

on January 20, 1969 (App. C, *infra*, p. 12a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Where the depletable "gross income from mining" of an integrated miner-manufacturer of cement must be determined under the "proportionate profits" method, *i.e.*, an allocation of the receipts from the sale of its manufactured product to the mining phase of its operation in the ratio that its mining costs bear to its total (mining plus non-mining) costs:

1. Whether, in determining the ratio of mining to total costs, post-manufacturing costs of storage, distribution and sales may be left out of account, as the court below held, or are to be considered non-mining costs and included as part of the total cost figure?

2. Whether, in determining the amount of income to be allocated in accordance with the cost ratio, the income is to be computed on the assumption that only cement sold in bulk is the first marketable product, even though respondent sold substantial quantities of the same cement in bags at higher prices and with higher post-manufacturing costs?

3. Whether respondent's "mining" costs with respect to calcium carbonates include the expense of processing mineral additives purchased from and separately depleted by other miners?

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the Internal Revenue Code of 1954 and the regulations thereunder are set forth in Appendix D, *infra*, pp. 13a–20a.

STATEMENT

Respondent is an integrated producer of portland cement, with mining and manufacturing facilities in a number of southern and western states. The major ingredient of portland cement is calcium carbonate, derived from limestone or other deposits (such as oyster shell) with a high calcium carbonate content. Except for its Gulf Coast operations, where it uses shell, respondent mines its own calcium carbonate deposits and crushes the raw mineral. It then grinds the material into kiln feed, in some cases adding purchased sand, sandstone, oyster shell and iron ore to produce a feed with properly balanced constituents. The kiln feed is heated in rotary kilns to produce clinker, and the clinker is then ground together with gypsum to produce the finished cement powder, which is stored in silos. (R. 66–67, 70–74.)

During the taxable years in question (1951 through 1954) respondent sold cement both in bulk and in bags. It sold bulk cement directly from the silos at various plants and from its distribution terminal at New Orleans. It advertised its cement widely and operated sales offices in eleven states. The costs of marketing bulk cement included the costs of bulk loading, transportation and, as to two plants, the operation of the New Orleans terminal, and reloading there for shipment. Some bulk cement was bagged at various plants and some at the New Orleans terminal. Cement in bags was sold from the plants, the New Orleans terminal and respondent's warehouse in Salt Lake City. The costs of bags and bagging were above those incurred in marketing bulk cement, and respondent

charged an additional price for cement in bags (the "bag premium"). (R. 68, 73–74.)

In its complaint as originally filed in the district court on April 21, 1959, as in the underlying claims for refund, respondent contended that its "gross income from mining" for determining its depletion allowance for the years 1951 through 1954 should be computed on the basis of the sales price of finished cement. (R. 69.) [2]

Thereafter, however, respondent filed amended returns for the taxable years and an amended complaint reflecting its election to compute its "gross income from mining" for the taxable years at the kiln feed cut-off point. (R. 68–69.) [3] It was undisputed that respondent's "gross income from mining" at the kiln feed cut-off point had to be determined under the proportionate profits method. (R. 68, 74–75.) This method has been prescribed by successive Treasury Regulations since 1940.[4] It allocates the gross

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[2] The applicable statutory provisions for the taxable years 1951 through 1953 were Sections 23(m) and 114 of the Internal Revenue Code of 1939. The successor provisions applicable to the taxable year 1954, set forth in Section 613(a) and (b) of the 1954 Code, are substantially similar to the extent pertinent here, and are set forth in Appendix D, *infra*.

[3] This election was authorized by Section 4 of the Act of September 14, 1960, P.L. 86–781, 74 Stat. 1017, and allowed respondent to compute its "gross income from mining" for the taxable years under Section 613(c)(4)(F) of the 1954 Code, as added by Section 302(b) of the Public Debt and Tax Rate Extension Act of 1960, P.L. 86–564, 74 Stat. 290.

[4] Treasury Regulations 103 (1939 Code), Section 19.23(m)–1(f); Treasury Regulations 111 (1939 Code), Section 29.23(m)–1, applicable to the taxable year 1951 herein; Treasury Regulations 118 (1939 Code), Section 39.23(m)–1(e)(3), Ap-

sales price of the integrated miner-manufacturer's first marketable product between the mining and non-mining phases of its operations in the same ratio as the costs of its mining processes bear to its overall costs.

At trial the use of the proportionate profits method gave rise to several questions regarding the proper treatment of certain of respondent's costs. The district court sustained respondent's contentions 1) that all of respondent's post-manufacturing costs of storage, distribution, and marketing should be allocated between mining and non-mining costs in the same ratio that mining costs bore to the total of mining and manufacturing costs; and 2) that respondent's costs of bags and bagging should be allocated in the same manner. The court also ruled that respondent's gross receipts from sales of cement in both bulk and bags was the income figure to be allocated in accordance with the cost ratio, a subject that was not then disputed. Finally, it ruled that respondent's costs of processing purchased additives, extracted and depleted by other miners, should be included in respondent's "mining" costs with respect to the mining of its calcium carbonate deposits.[5]

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pendix D, *infra*, applicable to the taxable years 1952 and 1953; Section 1.613–3(d), Appendix D, *infra*, applicable to the taxable year 1954.

[5] Additional issues were raised as to the timeliness and merits of amendments respondent made to its claims for refund and its complaint. Those amendments involved the proper classification of certain minerals mined by respondent and the depletion rates application thereto. Both courts below ruled that the amendments were timely and that respondent's contentions as to rates were correct. See App. A, *infra*, pp 2a–3a. Those rulings are not questioned here.

The majority of the court of appeals rejected the district court's theory for apportioning post-manufacturing costs, agreeing with the government that such costs are non-mining in their entirety. However, it ruled that such costs (Appendix A, *infra,* p. 6a) "are not a proper part of the * * * computation", *i.e.,* should not enter into the total cost figure in the cost ratio. In arithmetic result, this was the same as the district court's, *i.e.,* income is to be allocated by the ratio that mining costs bear to the total of mining plus manufacturing costs. The majority further accepted respondent's alternative argument on appeal that its costs and receipts should be determined on the assumption that all of its cement was sold in bulk, reversing the district court's ruling that sales in bags should be taken into account. Finally, it sustained the district court's ruling that the costs of processing purchased additives are mining costs. The United States' resulting petition for rehearing *en banc* was denied (App. C, *infra,* p. 12a).

REASONS FOR GRANTING THE WRIT

The rulings below are variously in conflict with the views of the Courts of Appeals for the Third and Ninth Circuits and the Court of Claims. The result is confusion and uncertainty in an area of tax law that affects, in the first instance, the numerous members of the integrated portland cement industry who are located throughout the country. Potentially affected are all integrated miner-manufacturer industries, since the proportionate profits method is necessarily applied in computing the depletion allowances

of their members. Only through review by this Court can the conflict and confusion be resolved and a uniform method be established for nationwide application.

1. Section 611(a) of the Internal Revenue Code of 1954, App. D, *infra,* p. 13a, authorizes—as did Section 23(m) of the 1939 Code—a "reasonable allowance for depletion" of natural deposits "in all cases to be made under regulations prescribed by the Secretary or his delegate". In the case of hard minerals, the allowance is a specified percentage of "gross income from mining". Sections 613(a) and (b) of the 1954 Code, App. D, *infra,* pp. 13a–14a. The rate for limestone (or calcium carbonate rock), from which cement is made, was 10 per cent under the 1939 Code provision applicable to the taxable years 1951 through 1953, and 15 per cent under the 1954 Code provision applicable to the taxable year 1954.[6]

If a miner does not conduct manufacturing operations, *i.e.,* if he does not "destroy the physical or chemical identity of the minerals or permit them to be transformed into new products," *United States* v. *Cannelton Sewer Pipe Co.,* 364 U.S. 76, 86, his "gross income from mining" is usually his actual gross receipts from the sales of the raw material. In the case of an integrated producer—one who does not sell the raw mineral he mines but uses it in his own manufacturing operations—"gross income from mining" is the producer's constructive income from the raw mineral product of his mining operations. See *ibid.*

[6] Section 114(b)(4)(A)(ii) of the 1939 Code; Section 613(b)(7) of the 1954 Code, Appendix D, *infra,* p. 14a.

The governing Treasury Regulations[7] provide two methods for determining the constructive "gross income from the mining" of an integrated miner-manufacturer. Under both methods the constructive figure is derived from actual sales data. If a representative price for the raw mineral is established by arm's-length sales in a relevant market—by the taxpayer or another miner—that price is the measuring-stick of constructive mining income for the raw mineral which the integrated producer uses in his own manufacturing operations. But if such a representative price cannot be established because the raw mineral is not generally sold on the open market—as in the integrated cement industry—then the producer's constructive mining income is derived under the proportionate profits method from his own sales price of his manufactured end product.

The objective of the proportionate profits method is to identify the portion of an integrated producer's gross sales that has been produced by the costs of his mining operations; that portion is the producer's constructive mining income. In substance the method, long established under the Treasury Regulations,[8] apportions gross sales receipts between mining and non-mining income in the same ratio as the producer's mining costs bear to its overall costs.

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[7] The successive Regulations applicable to the taxable years involved are listed p. 4, n. 4, *supra*.

[8] The method was first prescribed under the 1939 Code in Treasury Regulations 103 (1940), Section 19.23(m)-1(f).

This apportionment is reflected in the following single equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales of cement} = \text{Gross income from mining}$$

Riddell v. *California Portland Cement Co.*, 330 F. 2d 16 (C.A. 9); *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F. 2d 468 (C.A. 3). The basic theory of the method is that every dollar of the producer's costs, mining and non-mining alike, is deemed to produce the same proportionate part of the profits earned through sales of the first marketable end product; and it is the gross receipts from such sales which are apportioned in accordance with the cost ratio. *Standard Lime and Cement Co.* v. *United States*, 329 F. 2d 939 (Ct. Cl.); *Whitehall Cement Manufacturing Co.* v. *United States, supra*; *United States* v. *Portland Cement Co. of Utah*, 378 F. 2d 91 (C.A. 10), certiorari denied, 389 U.S. 975. The premise that every dollar of costs produces the same ratable part of the profits is in accord with long-settled principles of corporate accounting. See Paton and Littleton, *An Introduction to Corporate Accounting Standards* (American Accounting Association, 1940), p. 67.

2. (a) The decision below to exclude post manufacturing costs from the proportionate profits computation is in conflict with the Court of Claims' decision in *Standard Lime and Cement Co.* v. *United States, supra,* and the Third Circuit's decision in *Whitehall Cement Manufacturing Co.* v. *United States, supra.* In *Standard Lime* the Court of Claims, stressing (329 F. 2d at 944) the basic theory of the method that "each dollar of costs expended to produce and sell

the end product earns the same percentage of the profit," assigned (*id.* at 945, n. 13) a proportionate part of the taxpayer's profits to its post-manufacturing costs of transporting and marketing its cement.[9] Similarly, in *Whitehall Cement,* the Third Circuit ruled that the taxpayer's post-manufacturing costs of bulk loading for shipment had to be treated as costs of non-mining activities.

Thus, *Whitehall Cement* and *Standard Lime and Cement* require that all non-mining costs be taken into account and that costs such as those in issue here, together with a proportionate part of the profits, be excluded from the depletable "gross income from mining."

(b) The decisions of the Court of Claims and the Third Circuit are correct, and the decision of the majority of the Tenth Circuit in this case is erroneous. No expense may be "eliminated" from or deemed "not a proper part" of the proportionate profits method, for the underlying accounting theory is abrogated unless a producer's gross sales are allocated in accordance with a cost fraction which includes in its denominator all of the costs producing the sales. The determination of the integrated miner-manufac-

[9] *Standard Lime* articulates the computational approaches in a different manner than *Whitehall*—but achieves the same end result, because the same basic theory was applied. *Standard Lime* reflects the literal description of the proportionate profits method in the 1939 Regulations applicable to the earlier taxable years here involved. Under that prescription non-mining costs *together with* their proportion of the profits are subtracted from gross sales. This manner of working back from gross sales maintains the proper correspondence between a constructive income figure and related costs as of any point in an integrated producer's operations.

turer's "gross income from mining", requires an allocation of all its income from sales of its end product between the mining and non-mining phases of the company's operations. *All* costs and *all* of the profit must be allocated to either the mining or the non-mining part of the operation. If an item of expense in fact results from the mining phase of the business, it should be included in the "gross income from mining", and also carry into "gross income from mining" its ratable share of the company's profit or loss. By the same token, every cost that is attributable to the non-mining operations, together with its allocable share of profit or loss, must be excluded from the depletion base. Otherwise the depletion allowance will not be restricted to its intended ambit, the return of the miner's capital interest in depleting minerals.[10]

In the case at bar, the majority of the court below did not recognize that *all* of the costs of producing cement had to be taken into account in determining the cost ratio. It correctly characterized as non-mining the substantial post-manufacturing costs, *i.e.*, those of bulk loading, bags and bagging, operating storage warehouses and distribution terminals, and the transportation thereto, as well as the costs incurred by respondent to advertise and to sell its cement. But it refused to apply the basic theory of the proportionate

[10] Recently adopted Treasury Regulations on Income Tax, Section 1.613–3(d)(1)(i), App. D, *infra*, explicitly provide—in keeping with *Standard Lime* and *Whitehall Cement*—that "each dollar of the total costs paid or incurred to produce, transport and sell the first marketable product or group of products earns the same percentage of the profit". These Regulations are applicable to the fourth taxable year (1954) involved in this litigation.

profits method to these costs, by excluding them from the denominator (total costs) of the cost fraction. This in effect puts part of the post-manufacturing costs and their allocable share of profits within respondent's depletion base, for it requires the allocation of *all* sales income by a ratio that includes only mining and manufacturing costs in the denominator. Thus it has done indirectly what the district court did directly: include non-mining costs and non-mining profit in respondent's "gross income from mining". As the dissenting judge observed below (App. A, *infra*, p. 8a), this "reaches a result that is a rejection of the basic theory of the proportionate profits method itself." So long as the majority decision stands, the proportionate profits method, as long established by Treasury Regulations and approved by other federal courts, will not be applied in the Tenth Circuit, and an integrated producer having his tax home there may have his constructive mining income and therefore his depletion improperly augmented.

3. The decision below that respondents' gross sales should be determined on the assumption that all its cement was sold in bulk[11] is in conflict with the decision of the Third Circuit in *Whitehall Cement*. In the Third Circuit, the taxpayer argued that the costs incident to and premiums charged for cement

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[11] In the court below respondent, while urging in the alternative the result reached by the court, asserted that that result would decrease its depletion base. (See its brief in the court below at p. 24, n. *.) This is true, however, only if respondent prevails, as it did below, on the first question presented and if the bag premium is less than the pertinent packaging costs.

sold in bags should be excluded from the proportionate profits calculation, on the theory that the bagging costs were more than the premium so that those costs could not fairly be considered to have produced a proportionate share of the manufacturer's overall profits. The Third Circuit rejected this argument as resting on (369 F. 2d at 474) "an erroneous assumption that the packaging costs produced only the additional revenue derived from the premiums * * *. It seems reasonable to infer that the profits realized from the sale of packaged cement, and these were substantial, were attributable at least in part to the packaging costs." The court, therefore, held that the packaging costs must be included in the denominator of the proportionate profits equation as a non-mining cost and that the premiums should be included in gross sales.

There is no basis for the theory invoked by the majority opinion here.[12] It asserts that cement in bulk is the first marketable product, so that the bulk price should be the assumed price for all sales of cement. But the nature of the product depends on its physical and chemical characteristics. See *United States* v. *Cannelton Sewer Pipe Co., supra,* 364 U.S. at 85–86. Neither the quantities nor the packages in which it is sold, and which determine the per unit price, affect the nature of the product. The proportionate profits method requires an allocation of the actual gross

[12] The recently adopted Treasury Regulations on Income Tax, Section 1.613–3(d)(1)(iv), App. D, *infra*, provide that the "gross sales" of the first marketable product shall include sales both in bulk and in bags. This applies to the last year in issue here, 1954.

receipts received upon the sale of that product, and that must be determined, as it was in the Third Circuit, solely on the basis of the prices in fact charged for the commodity regardless of variations depending on such things as packaging.[13]

4. The ruling below that petitioner's expenses of processing purchased additives, in connection with preparing the kiln feed, are mining costs is in conflict with the rationale of the Court of Appeals for the Ninth Circuit in *Riddell* v. *California Portland Cement Co.*, 330 F. 2d 16.

That case holds that the costs of acquiring additives are non-mining costs. Here the question is slightly different in form, but the answer must be the same. The definition of mining in Section 613(c)(4) speaks of "treatment process * * * *applied* to the * * * mineral" that is the subject of depletion. In consequence,

[13] The decision below also appears to conflict with the reasoning in *Riddell* v. *Victorville Lime Rock Co.*, 292 F. 2d 427 (C.A. 9). That was not a proportionate profits case, but required a determination of whether the taxpayer-miner's gross income from mining should be computed on the basis of his sales of limestone in bulk or the higher [redacted] price charged for limestone sold in bags. In holding that (*id.* at 436) "[b]ags and bagging are not required in order to obtain the commercially marketable mineral product", and that the miner's depletion basis should not include "[i]ncome attributable to bags and bagging", the Ninth Circuit in substance ruled that the cost of bags and bagging and the resulting premiums were not attributable to the mining. The court's statement (*ibid.*) that "[b]ags and bagging was not required in order to obtain the commercially marketable mineral product", taken out of context, could be read as supporting the decision here. But it must be viewed as a definition of the end of mining, and not as a determination of the sales price to be used in a proportionate profits allocation.

a processing cost can be characterized as a mining cost only if it represents treatment of the mineral that is the subject of the particular proportionate profits computation. As stated in the preamble to Section 613(c)(4), App. D, *infra*:

> The following treatment processes where applied by the mine owner or operator shall be considered as mining *to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under Section 611:* [Emphasis supplied.]

See, also, H. Conf. Rep. No. 2005, 86th Cong., 2d Sess., pp. 8–9.

Under these authorities, the decision of the Ninth Circuit in *California Portland Cement* is correct and the decision below is not. The decisive point, in the Ninth Circuit's language, is that there must be (330 F. 2d at 18) "separate computations of depletion of component minerals." If either the cost of acquiring additives or the cost of processing them could be added to the cement manufacturer's mining costs, he would be obtaining a depletion allowance with respect to the additive over and above that available upon the mining of that additive. Therefore, each mineral component of the kiln feed may be depleted only by the taxpayer who mined it, and only in the manner applicable to that mineral. Rev. Rul. 290, 1953–2 Cum. Bull. 41. The miner and seller of the additives in issue here had the right to deplete them, and a buyer such as respondent plainly does not.

5. The conflicts between the decision here and those of the Court of Claims and the Third and Ninth

Circuits is a matter of substantial importance in the administration of federal revenue laws. The most direct impact is on miner-manufacturers of portland cement, who have tax homes throughout the nation and manufacture the most widely used construction material.[14] Thus even within this one industry, the issues of this case are of substantial nationwide significance.

The importance of these questions, moreover, extends beyond this one market place, for they will generally arise whenever the proportionate profits method is used. It will apply to miner-manufacturers of light-weight aggregate, brick, tile, and other vitreous products. We are advised, moreover, that the Internal Revenue Service has in some circumstances found it necessary to use the proportionate profits method in the case of iron ore, coal, limestone, bauxite, crushed and broken stone, and lignite.[15] The post-manufacturing costs involved here are, for tax purposes, indistinguishable from the costs of storage, distribution, and marketing incurred by any other

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[14] The portland cement industry in 1963 comprised some two score companies having 181 producing plants in 40 states and Puerto Rico with a total production capacity of 478 million barrels. See *Mineral Facts and Problems*, Bureau of Mines Bulletin 630 (1965 ed.), p. 189.

[15] The extent of the potential difficulties in industries other than portland cement, may be demonstrated by the fact that in 1953 50.2 million tons of clay, valued at $181,000,000, were produced from 1,300 mines by about 1,000 firms, for use in manufacturing building brick and tile, sewer pipe, terra cotta, lightweight aggregates and refractory products. About 97 percent of the miscellaneous clay and 70 percent of the fire clay was extracted from mines owned or controlled by integrated producers. *Id.* at 228.

integrated miner-manufacturer, whatever the mineral he mines and the end product he ultimately sells. The same may be said of the problems of determining the appropriate treatment of the cost of bags and bagging, for it is common throughout industry for one commodity to be sold in different quantities at different per unit prices as well as with different packaging. And the problem of the proper treatment of additives and the costs of processing them also occurs with frequency, since there are a variety of minerals the mining of which is defined in Section 613(c) to include processes that may result in the addition of other depletable materials.

There are currently 22 proportionate profits cases being litigated in various courts, involving in excess of $6,000,000. Many of these cases involve, as does the instant case, taxable years in the early 1950's. The taxpayers' subsequent years are open on refund claims awaiting the outcome of litigation, so that many millions more in revenue are in fact involved.[16]

The tax liabilities of miner-manufacturers in integrated industries may be determined in an orderly and uniform fashion only if this Court resolves the conflict that has arisen among the lower federal courts.

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[16] The amount involved in controversies pending at the administrative level is not susceptible of present evaluation.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APRIL 1969.

APPENDIX A

United States Court of Appeals

Tenth Circuit

July Term 1968

No. 9571

UNITED STATES OF AMERICA, APPELLANT

v.

IDEAL BASIC INDUSTRIES, INC., APPELLEE

Appeal From the United States District Court for the District of Colorado, Civil No. 6384

Before MARVIN JONES,* LEWIS and HICKEY, Circuit Judges

HICKEY, *Circuit Judge.*

Appellee, Ideal Basic Industries, Inc., for itself and its merged affiliate, Pacific Portland Cement Co., sues for refund of income and excess profit taxes paid for the years 1951 through 1954. The trial court granted the refund claimed by appellee. The government appeals. Jurisdiction is conferred by 28 U.S.C. § 1291.

The appeal presents two questions: (1) Are taxpayer's claims for the years 1951, 1952, and 1954 with respect to the Ada, Oklahoma, plant barred by failure to present a claim for refund within the period of

* Senior Judge, United States Court of Claims, sitting by designation.

limitations? (2) Is the determination of "Gross Income from Mining" properly made under the proportionate profits method of computation when certain costs are introduced into the proportionate fraction? The specific costs to be considered are:

1. Cost of processing additives.
2. Cost of bags and bagging.
3. Cost of bulk loading.
4. Cost of operating storage warehouses, distribution terminals, and the transportation thereto.
5. Costs of advertising, promoting and selling cement.

The facts are not in dispute. Appellee is an integrated miner-manufacturer. The first market price available is for the finished product, bulk cement, therefore, depletion is computed on the hypothetically derived value of "kiln feed." 26 U.S.C. § 613(c)(4)(F). Appellee made timely election to use the proportionate profits formula to compute its "Gross Income from Mining" which would be subject to depletion.

We consider initially the procedural question relative to the period of limitations provisions.

All refund claims were initially filed on time, and all except the Ada, Oklahoma, claims were based upon the depletion percentage for limestone. In its 1951–53 returns, appellee claimed the calcareous material at Ada was calcium carbonate, depletable at 10%. In its 1954 return, appellee claimed the argillaceous material at Ada was shale, depletable at 5%. Later the appellee amended its 1951–53 claims relating to Ada, Oklahoma, to identify the calcareous material as chemical grade limestone, depletable at 15%. The 1954 claim was amended to identify the argillaceous material as clay, depletable at 15%. The commissioner denied the amended claims for 1951, 1952, and 1954 on

the ground they were filed out-of-time. The trial court reversed and allowed the amended claims.

The test applied to determine, "[w]hether a new ground of recovery may be introduced after the statute has run by amending a pending claim filed in time depends upon the facts which an investigation of the original claim would disclose. Where the facts upon which the amendment is based would necessarily have been ascertained by the commissioner in determining the merits of the original claim, the amendment is proper." *Pink* v. *United States,* 105 F. 2d 183, 187 (2d Cir. 1939). (citations omitted). "The test is one which affords the government ample protection against the filing of stale claims * * * while at the same time providing no arbitrary limit on the amendment of claims previously filed." *St. Joseph Lead Co.* v. *United States,* 299 F. 2d 348, 350 (2d Cir. 1962). (citations omitted).

The trial court found the contested mineral identification issues in favor of the taxpayer. When the initial claim was filed it was incumbent upon the commissioner to identify the minerals upon which depletion was claimed. The findings clearly indicated the identity of the minerals as limestone and clay, entitled to the 15% depletion rate. Therefore, the commissioner could not have been misled nor did the amendment introduce a new ground for recovery.

" 'If the Commissioner is not deceived or misled by the failure to describe accurately the claim, as obviously he was not here, it may be more convenient for the government and decidedly in the interest of an orderly administrative procedure that the claim should be disposed of upon its merits.' " *Reynold* v. *McMurray,* 77 F. 2d 740, 744 (10th Cir. 1935), quoting *Tucker* v. *Alexander,* 275 U.S. 228, 231 (1927).

We now turn to the question which involves the merits of the controversy.

This circuit has adopted the proportionate profits method for determining the "Gross Income from Mining" for the purpose of depletion in the miner-manufacturer product, cement. *United States* v. *Portland Cement Co.*, 378 F. 2d 91, 93 (10th Cir. 1967).

$$\text{Gross Income from Mining} = \frac{\text{Mining Cost}}{\text{Total cost of [bulk] cement}} \times \text{Sales price of first marketable product, i.e., [bulk] cement.}^{1}$$

"This method works back to the end result by reducing the representative market or field price of the taxpayer's first marketable product by his non-mining costs plus the proportionate profits allocable to his non-mining activity. For this purpose profits are allocated between mining and non-mining activities in the proportion that the taxpayer's non-mining costs bear to his total costs." Hamovit, Depletion for the Integrated Miner-Manufacturer, 13 Rocky Mtn. Mineral L. Inst. 411, 422 (1967).

The trial court found: "The grinding and blending of prekiln additives was incidental to the grinding and blending of plaintiff's own materials." *Ideal Cement Co.* v. *United States*, 263 F. Supp. 594, 601 (D. Colo. 1966). We agree, therefore, we would not

[1] The numerator, mining costs, is the cost of the process including applicable overhead up to and including kiln feed. The denominator, total cost of bulk cement, is the cost of the bulk cement, or stated another way, the total cost of mining and non-mining activities including the overhead and administrative cost attributable to mining and non-mining activities. The multiplier, sales price of first marketable product, is the sales price of bulk cement. It may be helpful to note that the sales price of the first marketable product is to be computed on the identical physical material that is represented by total mining and non-mining costs.

deduct the costs from the numerator (mining costs) in the proportionate formula. Other courts have so held. *Whitehall Cement Mfg. Co.* v. *United States,* 237 F. Supp. 838 (E.D. Pa.), *modified,* 242 F. Supp. 326 (E.D. Pa. 1965), *aff'd without discussion of this issue,* 369 F. 2d 468 (3d Cir. 1966); *Riddell* v. *California Portland Cement Co.,* 330 F. 2d 16 (9th Cir. 1964).

We conclude that "first marketable product" is the proper sales price to which the application of the formula was intended, therefore, the costs of bags, bagging, and bulk loading should be eliminated from all parts in the formula. "Consequently we must hold that those packing and loading costs are indirect costs which are not incurred for the benefit of the entire operation and as such *cannot be included in taxpayer's computation of gross income* from the property at kiln feed." *Standard Lime & Cement Co.* v. *United States,* 329 F. 2d 939, 948 (Ct. Cl. 1964) (emphasis added); *accord, United Salt Corp.,* 40 T.C. 359 (1963). Equally compelling is the simple logic that bulk cement is the first marketable product,[2] bagged cement is the second marketable product, as for example "sakrete"[3] would be a third marketable product.

The cost of operating storage warehouses, distribu-

[2] Bulk cement is the first marketable product because it *can* be sold. The Supreme Court, in *United States* v. *Cannelton Sewer Pipe Co.,* 364 U.S. 76 (1960), held that a sale only needed to be possible. Certainly bulk cement is saleable. Only the details of the manner of loading and whether the buyer or seller bears the loading costs need be resolved. The fact is that bulk cement is marketable. In addition there is no earlier point in the manufacturing procedure where the "goods in process" can be sold.

[3] "Sakrete" is a bagged mixture of cement, sand, and gravel to which water may be added to make concrete.

tion terminals, and the transportation thereto are, on their face, non-mining and non-processing costs. The basic principle concerned is to allow a deduction to compensate for the depleting resource and, therefore, the formula is oriented to the value of the resource at the time of its extraction rather than to the ultimate sale price of the manufactured product. Transportation, governed by regulated rates, does not add to or detract from the appellant's profit as computed for bulk cement and is not a proper part of the "Gross Income from Mining" computation. The operation of warehouses and of distribution terminals are marketing facilities for the manufactured product and are, therefore, cost oriented to the value of the manufactured product rather than the value of the depleted resource. Both should be eliminated from the formula to arrive at the gross resource income. *Standard Lime & Cement Co.* v. *United States,* 329 F. 2d 939 (Ct. Cl. 1964). *See Commissioner* v. *American Gilsonite Co.,* 259 F. 2d 654, 657 (10th Cir. 1958).

The advertising, promotional, and selling costs are not a proper part of the computation. These costs, like bagging (packing) and loading costs are overhead charges properly applicable to finished cement after it has become "first marketable product." The selling, advertising, promotional, loading, bagging, and transportation costs are all distribution costs to get the finished cement from the point of completed manufacture to the next user. A hypothetical model to test this point would be the case of a cement block manufacturer with facilities adjacent to the cement plant.

If the block manufacturer utilized all of the output of the cement plant, then there would not be any necessity for the cement manufacturer to incur costs of distribution. The cement manufacturer would not

incur selling, advertising, promotional, loading, bagging, or transportation expenses. "We are of the opinion that all of taxpayer's * * * costs are distribution expenses which cannot be allocated by taxpayer in its computation of gross income from the property at kiln feed." *Standard Lime & Cement Co.* v. *United States,* 329 F. 2d 939, 948 (Ct. Cl. 1964). The assumption of the proportionate profits formula is that in the absence of a market price for the mined product, i.e., chemical grade limestone, an artificial price for "kiln feed" must be computed. The artificial price is predicated upon a real price which is determined in a hypothetically free market place. The intent is to establish this real market price as near the mine as possible, therefore, the liturgy of "first marketable product." First marketable product means the cost of bulk cement, and that means the cost of mining plus the cost of processing to the point that the bulk cement is delivered to the silo from the final milling, plus those overhead items which may be fairly attributable to mining and processing. Overhead amounts dealing with sales cannot be logically attributed to mining as the government points out. Likewise, these items of overhead are equally inapplicable to the process from the "kiln feed" point to the silo. The logic of this approach is, the closer to the mine that the mining costs, the cost of bulk cement, and the free market price can be established, the smaller the possibility of distortion of the depletion figure, and the fairer the result for the taxpayer and the government.

The fallacy of the appellee's argument that the teaching of *United States* v. *Cannelton Sewer Pipe Co.,* 364 U.S. 76 (1960), is parity among miners is that the hypothetical sales expense of a limestone mine selling to a cement manufacturer is a different

fact situation from a cement manufacturer selling to a wide variety of end users. The appellee is seeking hypothetical equality between a miner and an economically distinct entity, a manufacturer. Under *Cannelton* the appellee is, in fact, entitled to include any sales expense he can demonstrate which can be attributed to the cost incurred by his mining operation in selling kiln feed to his processing, or manufacturing operation.

We therefore affirm in part and reverse in part and remand to the trial court for computation in conformance with this opinion.

Remanded.

LEWIS, *Circuit Judge,* dissenting.

I must dissent for it appears to me that the reasoning of the majority, abandoning as it does both the views of the trial court and the arguments of the parties, reaches a result that is a rejection of the basic theory of the proportionate profit method itself. The method, by relating gross sales proportionately to mining costs and total costs, purports to isolate for tax purposes income from mining from that attributable to non-mining activity. The basic equation is:

$$\frac{\text{mining costs}}{\text{total costs}} \times \text{gross sales} = \text{gross income from mining}$$

The formula is cost-oriented and assumes the premise that each dollar of cost is reflected proportionately in profit. This premise is, of course, one of convenience and practical necessity but artificial and thus lends itself to easy attack when specific items of cost are allocated to or excluded from the formula. Common sense dictates that if unproductive costs so corrupt the formula as to patently distort the reality of result such costs should be eliminated from the equa-

tion. *United States* v. *Portland Cement Co. of Utah*, 10 Cir., 378 F. 2d 91, 92–93. But elimination of a specific element of cost must be the exception for the proportionate profit method assumes that every item of cost, directly attributable to mining or not, is incurred for the benefit of the integrated business and must therefore be reflected in both cost and gross sales if the equation is to be acceptable.

The trial court held that Ideal's first marketable product was cement, whether sold in bulk or in bags, and allocated the element of bag expense within the cost fraction as a balance to the inclusion of such cost in total sales. Since the actuality of this particular company's selling practice shows that bagging amounts to but a premium charge there may be justification for this view although I would agree with the United States that the cost of bagging, in general, is a non-mining cost. The main opinion, however, rejects the finding that cement is Ideal's first marketable product, finds that bulk cement is such product, and then eliminates the cost of bagging completely from the equation. I would include such cost under either finding for certain it is that the quantity of bulk cement sold is increased by bagging and its contribution to gross sales thus actually exceeds the simple premium cost of bags.

As I have indicated, I can see some separate merit to the arguments of the parties that the cost of bagging should be included only in the denominator of the subject fraction (as argued by the United States), allocated between the numerator and denominator as the trial court determined (as supported by the argument of the appellee) or even eliminated from the equation because of the premium nature of the item to this particular company's cost (as advanced as an

alternative position by appellee). And these contentions of the parties have been projected in support of or as an attack upon the judgment of the trial court whose decision treated each other item (such as transportation, warehousing, distribution and selling costs, etc.) with particularity and, with some exceptions, allocated a portion of these costs to mining. Since the main opinion with a broad sweep apparently eliminates all these costs and expenses from inclusion within the formula it would serve no present purpose to express my agreement or disagreement with those aspects of the judgment below. It is sufficient to note that neither the United States nor the taxpayer has made any suggestion that consideration of these items is not proper within the bounds of the proportionate profit method. Their disagreement lies with where and how such costs should be placed within the equation. I consider that to be the issue presented to us and inherent in the application of the proportionate profit method. To eliminate all post-manufacturing costs destroys consideration of the representative market or field price of the first marketable product, a prime factor in the application of the equation, and thus seems to me to reject the method itself.

I agree that taxpayer's claim is not barred by limitation.

Dated August 15, 1968.

APPENDIX B

July Term, Thursday, August 15, 1968

UNITED STATES OF AMERICA, APPELLANT

vs.

IDEAL BASIC INDUSTRIES, INC., APPELLEE

Appeal From the United States District Court for the District of Colorado

No. 9571

Before Honorable MARVIN JONES, Judge, United States Court of Claims, and Honorable DAVID T. LEWIS and Honorable JOHN J. HICKEY, Circuit Judges

This cause came on to be heard on the transcript of the record from the United States District Court for the District of Colorado and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said district court in this cause is affirmed in part and reversed in part, and the cause remanded to the trial court for computation in conformance with the opinion of the court.

Honorable DAVID T. LEWIS, *Circuit Judge,* dissented.

Dated August 15, 1968.

APPENDIX C

January Term, January 20, 1969

No. 9571

UNITED STATES OF AMERICA, APPELLANT

vs.

IDEAL BASIC INDUSTRIES, INC., APPELLEE

Appeal From the United States District Court for the District of Colorado

Before Honorable ALFRED P. MURRAH, Chief Judge, and Honorable DAVID T. LEWIS, Honorable JEAN S. BREITENSTEIN, Honorable DELMAS C. HILL, Honorable OLIVER SETH, Honorable JOHN J. HICKEY and Honorable WILLIAM J. HOLLOWAY, Jr., Circuit Judges

This cause came on to be heard on the petition of appellant for a rehearing herein en banc and was submitted to the court.

On consideration whereof, it is ordered by the court that the said petition for rehearing en banc be and the same is hereby denied.

Honorable DAVID T. LEWIS and Honorable WILLIAM J. HOLLOWAY, Jr., voted for rehearing en banc.

APPENDIX D

Internal Revenue Code of 1954:

SEC. 611.[1] ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

* * * * *

[26 U.S.C. 611.]

SEC. 613.[2] PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property * * *.

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[1] Section 23(m) of the Internal Revenue Code of 1939, applicable for taxable years beginning before December 31, 1953, is substantially the same as Section 611(a) of the Internal Revenue Code of 1954.

[2] Section 114(b)(3) and (4) of the Internal Revenue Code of 1939, as amended by Section 145, Revenue Act of 1942, c. 619, 56 Stat. 798; Section 124, Revenue Act of 1943, c. 63, 58 Stat. 21; Section 207, Revenue Act of 1950, c. 994, 64 Stat. 906; and Section 319, Revenue Act of 1951, c. 521, 65 Stat. 452, applicable for taxable years beginning before December 31, 1953, is substantially the same as Section 613 of the Internal Revenue Code of 1954, as originally enacted. Section 613(c)(2) and (4) are set forth below as amended by Section 302(b) of the Public

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

* * * * *

(7) 15 percent—all other minerals (including but not limited to * * * limestone * * *), except that * * *

* * * * *

(c) *Definition of Gross Income from Property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.*—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * *

(4) *Treatment Processes Consideerd as Mining.*—The following treatment processes where applied by the mine owner or operator

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Debt and Tax Rate Extension Act of 1960, P.L. 86-564, 74 Stat. 290, since these amended definitions of mining were applicable to the taxable years involved by reason of respondent's election, as set forth in the text.

shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

* * * * *

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

* * * * *

[26 U.S.C. 613.]

Treasury Regulations 118 (1939 Code):

Sec. 39.23(m)–1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*

* * * * *

(e) As used in sections 114(b)(3) and 114(b)(4)(A) and sections 39.23(m)–1 to 39.23(m)–19, inclusive, the term "gross income from the property" means the following:

* * * * *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such represent-

ative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

* * * * *

Treasury Regulations on Income Tax (1954 Code):[3]

Sec. 1.613–3. *Gross income from the property.*

* * * * *

(d) *Sales after the application of non-mining processes where a representative market or field price cannot be ascertained*—(1) *Computation of gross income from the property by use of the proportionate profits method.* (i) If it is impossible to determine a representative market or field price as described in paragraph (c) of this section, then, except as provided in subparagraph (2) of this paragraph, gross income from the property shall be computed by use of the proportionate profits method. See § 1.611–0. The objective of the proportionate profits method of computation is to ascertain

[3] The provisions set forth in the text were published in the Federal Register on July 26, 1968, as T.D. 6965, 33 F.R. 10692, and are applicable to taxable years beginning after December 31, 1953.

gross income from the property by applying the principle that each dollar of the total costs paid or incurred to produce, transport and sell the first marketable product or group of products earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell and transport the first marketable product or group of products. See subdivision (iv) of this subparagraph for the definition of the term "first marketable product or group of products".

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). See subdivision (iv) and (v) of this subparagraph for the definitions of the terms "first marketable product or group of products" and "gross sales (actual or constructive)", respectively. The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, § 39.23(M)–1(e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{gross sales} = \text{Gross income from mining}$$

* * * * *

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. The first marketable product or group of products does not include a product or group of products additionally refined, beneficiated, altered, or manufactured as a result of the application of additional nonmining processes. For example, if a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him. * * *.

* * * * *

(4) *Treatment of particular items in computing gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. * * *

(ii) In determining gross income from the property by use of the proportionate profits method or any other approved method which

is based on the taxpayer's costs, a process shall not be considered as a mining process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nonmining costs in determining gross income from mining. If a mining process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining gross income from mining. Accordingly, all profits attributable thereto are treated as nonmining profits. In the absence of methods which will more clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, the cost attributable thereto shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining gross income from the property by use of the proportionate profits method (or any other approved method which is based on the taxpayer's costs)—

(*a*) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(*b*) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(*c*) The costs attributable to the operation of warehouses or distribution terminals for

manufactured products shall be considered as nonmining costs. Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from the property by means of the proportionate profits method or any other approved method based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613–4 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

* * * * *

[33 F.R. 10692; 26 C.F.R. 1.613–3.]

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